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Shining a light on tax avoidance

Hern Kuan LIU

Vincent OOI
Singapore Management University, vincentooi@smu.edu.sg

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The determining factor is the subjective intention of the taxpayer. Is the main purpose the avoidance or reduction of tax?

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LIU HERN KUAN
VINCENT OOI

OVER the past few weeks, there has been much interest in the issue of tax avoidance and whether high-earning professionals such as doctors and dentists have been engaging in tax avoidance schemes.

Tax avoidance is a technical legal term which has a precise meaning in law. This can be compared to the more general term of "tax dodging", which has no such technical legal meaning. In light of this, we think it might be useful to explain the concept of tax avoidance.

What is tax avoidance?

Tax avoidance occurs where an arrangement is entered into for the sole or main purpose of avoiding or reducing tax. In such cases, the arrangements are often artificial and contrived, and difficult to justify on the grounds of commercial (non-tax) reasons. The literature in this area describes such arrangements as having "little commercial substance", pointing out that it would not make commercial sense for the taxpayer to enter into such an arrangement if not for the tax benefits.

In Singapore, the test for tax avoidance was laid out by the Singapore Court of Appeal in 2014 in the case of Comptroller of Income Tax v AQQ. In summary, an arrangement would be considered to be tax avoidance if:

1) it generated a tax benefit;

2) its main purpose was to avoid or reduce tax;

3) it was not carried out for bona fide commercial reasons; and

4) it was availing itself of a tax benefit which Parliament did not intend to confer.

Effects of a finding of tax avoidance

When a firm is found to have entered into a tax avoidance arrangement, IRAS has the power to disregard the arrangement and tax the firm as if the arrangement does not exist. This power is limited to disregarding the arrangement for tax purposes only. In other words, the arrangement continues to exist for all other legal purposes.

For example, if a firm sets up a company for the sole reason of tax avoidance, IRAS can unwind the tax benefits by taxing the firm as if the company did not exist. However, the company remains able to enter into contracts with its suppliers. In effect, the only change is to the figures in the firm's tax assessment.

In Singapore, the consequences of a firm being found to have entered into a tax avoidance arrangement are limited to the unwinding of any tax benefits that the arrangement would have conferred. This is in contrast to countries like New Zealand, where the taxpayer may have to pay a penalty in addition to the unwinding of any tax benefits.

The law relating to tax avoidance in Singapore A question of intention

Under Singapore law, an arrangement is not a tax avoidance arrangement if a main purpose of the arrangement was not to avoid or reduce tax; or the arrangement was carried out for bona fide commercial reasons. The Court of Appeal determined in CIT v AQQ that this was to be assessed by looking at the subjective intention of the taxpayer.

Importantly, this requirement of considering the subjective intention of the taxpayer means that similarly structured transactions may be taxed differently depending on whether the taxpayer had intended to avoid tax. This point was expressly noted by the Court of Appeal in CIT v AQQ.

Thus, regardless of the arrangement entered into by the taxpayer, technically speaking, so long as the taxpayer subjectively did not have as the main purpose, the avoidance or reduction of tax, or carried out the arrangement for what it subjectively thought to be bona fide commercial reasons, there would not be any tax avoidance.

Legitimate reasons for incorporation

Given that the law requires the subjective intention of the taxpayer to be considered in the determination of whether there is in fact tax avoidance, any examples of tax avoidance that may be offered by IRAS can at most be useful illustrations on when tax avoidance might be found, and it does not conclusively follow that just because an arrangement falls within one of the listed examples, there must have been tax avoidance.

A doctor may well have multiple clinics and separately incorporate each clinic for reasons such as:

1) ring-fencing of risk - where any potential claims against any of the companies is limited to the assets in that particular company and not all the assets of the doctor or dentist;

2) differential pricing - where a doctor or dentist may charge different rates based on where the clinic is based (perhaps to charge lower rates in locations with less well-to-do patients);

3) asset creation - where a doctor or dentist may wish to build up the brand of one or more of the clinics and eventually sell off the business piecemeal.

The point is that there are a variety of non-tax reasons for incorporation and the law will only find tax avoidance if the taxpayer subjectively intended for the avoidance or reduction of tax to be the main purpose of an arrangement.

Subjective intention

It may well be the case that taxpayers with the reduction or avoidance of tax in mind are likely to use the company structures listed by IRAS. However, the determining factor is still the subjective intention of the taxpayer. Regardless of whether a taxpayer uses any of the company structures highlighted by IRAS, if it subjectively did not have as its main purpose the avoidance or reduction of tax, or carried out the arrangement for what it subjectively thought to be bona fide commercial reasons, there would not be any tax avoidance.

Firms which have knowingly entered into tax avoidance arrangements may wish to voluntarily disclose such schemes to IRAS, which has indicated that it will treat such a disclosure as a mitigating factor in its review of the case. However, firms which have had no intention of tax avoidance should not panic just because their company structure resembles those highlighted by IRAS.

- **Liu Hern Kuan is a consultant at Tan Peng Chin LLC and was previously the chief legal officer of the Inland Revenue Authority of Singapore for ten years.**
- **Vincent Ooi is an associate at Tan Peng Chin LLC and a lecturer at the Singapore Management University School of Law.**

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